Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:F:[redacted]:B:TL-POSTF-113921-02
[redacted]

date: October 1, 2002

to: LMSB Team
[redacted], Team Coordinator (LMSB), Group [redacted]

from: [redacted], Attorney
Associate Area Counsel, CC:LM:F:[redacted]

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subject: [redacted]/**Deferred Income**
TIN: [redacted]
Taxable year at Issue: [redacted]

This memorandum is in response to your request for Area Counsel Advice on the below described issue. We have deemed this advice to be non-docketed significant advice. As such it has been pre-reviewed by Associate Chief Counsel. This memorandum should not be cited as precedent.

ISSUE

Whether prepaid, non-refundable payments received by the taxpayer with respect to certain contracts entered into are includible in the year of receipt or are deferrable, ratably over the term of the contract. **U.I.L. Nos.: 451.13-01; 451.13-04; 471.00-00**

CONCLUSION

The prepaid, non-refundable payments received by the taxpayer with respect to certain contracts entered into are includible in income in the year of receipt. Further, these payments are not eligible for deferral under either Revenue Procedure 71-21 or Treas. Reg. § 1.451-5.

FACTS

Preliminary Overview

[redacted] (hereinafter [redacted]) and affiliates are being audited for the years [redacted] through [redacted]. The only year at issue with respect to this matter is the taxable year ending December 31, [redacted].

[redacted]

[redacted]

[redacted] further asserts that as a consequence of this [redacted], these [redacted] are [redacted]. Ex. [redacted]. Accordingly, there are no expenses to defer because as soon as the expenses would be accumulated in the [redacted], the [redacted] are used [redacted]. Id. Therefore, they argue that the subsidiaries have no inventory in any meaningful sense on hand at year-end. Id.

However, in earlier legal arguments, the taxpayer has argued that the income derived is from the sale of inventory. Ex. [redacted], pgs. [redacted]. The advance payments qualify under Treas. Reg. § 1.451-5 as advance payments for the future sale of inventory. Id. at [redacted]. The [redacted] is a manufacturing activity resulting in inventory. Id. pgs. [redacted].

It is our position [redacted]'s subsidiaries are not [redacted]. Rather, the contracts entered into are service contracts and some of the contracts, at least in part, are license agreements. In particular they are agreements to provide [redacted] to the purchaser over an agreed period of years. As an accrual-based taxpayer, income generally must be recognized when "all events" have occurred which fix the right to receive the income or the amount of the income can be determined with reasonable accuracy. Treas. Reg. § 1.446-1(c)(1)(ii); 1.451-1(a).

Here [redacted] through its subsidiaries received the specified amounts agreed to, which were non-refundable, in the [redacted] taxable year. These amounts received, whether for goods, as the taxpayer claims, or services were received without any restrictions as to their disposition. Therefore, [redacted] is required to include these amounts in its return as income in the taxable year [redacted], the year of receipt.

This office has contacted [redacted] We discussed the issue and were informed that, to the best of their knowledge, they were unaware of any taxpayer making a similar argument. We have also discussed the issue presented with Jeffrey Mitchell (I.R.C. § 471) and Kimberly Koch (I.R.C. § 451) of the National Office.

Background

[redacted] is a [redacted] company. [redacted] operates and provides [redacted] within that industry.

Beginning in [redacted], [redacted]. It covered approximately [redacted] throughout the United States. The [redacted] was completed sometime in [redacted].

The owners of the [redacted] are [redacted] wholly-owned subsidiaries of [redacted]: (a) [redacted] ([redacted]) and (b) [redacted] ([redacted]). Both [redacted] and [redacted] were part of [redacted]'s consolidated return for the

[redacted] taxable year.

A third wholly-owned subsidiary of [redacted], [redacted] ([redacted]) actually enters into the contracts which are at issue and more fully discussed below. [redacted] receives a [redacted]% trading commission. However, [redacted] does not file as part of the consolidated return. [redacted] and [redacted] provide the service.

During the [redacted] taxable year, [redacted] began entering into numerous contracts to sell [redacted] to third parties. The [redacted] varied in length from [redacted] to [redacted] years and included non-refundable, up-front payments.

The contracts are to provide [redacted] over this [redacted] to [redacted] year period. Per the schedules provided by the company, [redacted] received prepayments on these contracts of approximately $[redacted] in the [redacted] taxable year. Exs. [redacted]; [redacted]; [redacted]; [redacted]. Of this amount approximately $[redacted] and $[redacted] were transferred by [redacted] to [redacted] and [redacted] respectively for providing the [redacted] on the [redacted]. Id. [redacted] retained approximately $[redacted] as a so-called [redacted]. Exs. [redacted]; [redacted]. For book purposes all [redacted] companies deferred the income.

[redacted] filed a Form 1120 consolidated return for the taxable year ending December 31, [redacted] in [redacted]. In that return, [redacted] made certain schedule M-1 adjustments. These original schedule M-1 adjustments resulted in these amounts received by [redacted] and [redacted], which had been deferred for book purposes, being reported for tax purposes.

[redacted] had an extension to file the [redacted] return to [redacted]. [redacted] filed another return by the extension date. On this later return, there were no Schedule M-1 adjustments for the deferred income. On this later return the income was not reported for tax. Therefore, for book and tax purposes the income was deferred.

With the filing of this later return for [redacted] taxable year the taxpayer made an election to defer the income for tax purposes under the provisions of Treas. Reg. § 1.451-5(b)(1)(ii) and § 1.451-5(d). Exs. [redacted]; [redacted] Since the later return was filed by the due date including extension, the election was timely made. See, Goldring v. Commissioner, 20 T.C. 79 (1953); citing, Haggar Co. v. Helvering, 308 U.S. 389 (1940).

[redacted] filed only one return by the extension date. It did make a Schedule M adjustment to include the $[redacted] in taxable income.

[redacted] ([redacted]). [redacted] filed the [redacted] taxable year consolidated return on or about [redacted]. In accordance with Treas. Reg. § 1.451-5(d), [redacted] attached to the return a statement indicating that they were again relying on Treas. Reg. § 1.451-5(b)(1)(ii) to defer the income. Exs. [redacted]; [redacted]. The statement also provided in relevant part the following information concerning these advance payments:

A. [redacted]

[redacted] $[redacted]
$[redacted]

B. [redacted]

[redacted] $[redacted]
$[redacted]

C. [redacted]

% of inclusion

[redacted] $[redacted] [redacted]%
$[redacted] [redacted]%

[redacted]

[redacted]

[redacted]

[redacted]

Exhibit [redacted], pg. [redacted].

Thus [redacted] argues that pursuant to Treas. Reg. § 1.451-5(b)(i)(ii), the tax treatment of prepaid income will match the book treatment of prepaid income.

The taxpayer was also asked to provide an explanation of the accounting associated with the treatment of the prepaid income on the books [redacted], [redacted] and [redacted]. The taxpayer responded as follows:

[redacted] **Accounting**

[redacted]

[redacted]

Exhibit [redacted], pg. [redacted].

[redacted] Accounting

[redacted]

Exhibit [redacted], pg. [redacted].

The audit team also requested an explanation of how the cost of access relating to the prepaid income was treated for tax purposes by [redacted] and [redacted]. The company replied:

[redacted]

Exhibit [redacted], pgs. [redacted].

As set forth above, [redacted] refers to the contracts that [redacted] entered into with third parties as "[redacted]" and that their subject matter is the sale of [redacted] that are [redacted].

[redacted]

[redacted] refers to these contracts as an "[redacted]" or an [redacted] (hereinafter "[redacted]").

[redacted]

The [redacted] is not a standard separate category of interest that has been recognized at law. For example: [redacted]

[redacted]

[redacted].

[redacted]

None of the contracts submitted by [redacted] are specifically labeled "[redacted]". Further, nowhere in any of the contracts reviewed is the term "[redacted]" used, let alone defined.

Thus, any benefits, rights and obligations that an [redacted] may possess are the result of the specific terms of that particular agreement. Therefore a review of contracts is warranted.

Contracts

Each of the contracts at issue is referred to as a "[redacted]". The agreements are entered into between [redacted] and another party. This office has reviewed [redacted] of the contracts. See Attached Exhibits [redacted], and [redacted]. More can be secured if necessary. [redacted] listing of the total amount of [redacted] agreements are set forth in Exhibit [redacted].

[redacted] informed the audit team that although certain terms such as price and duration ([redacted] years) may vary, the contracts are generally similar.

The audit team did review all the relevant contracts. The three representative contracts attached state basically the same facts:

- [redacted]
- [redacted]

[2/] [redacted].

[3/]Note: In the contracts, reference is made to [redacted] which is in fact [redacted].

- [redacted]
- [redacted]
- [redacted]
- [redacted]
- [redacted]
- [redacted]

As a specific example, the contract between [redacted]. ("purchasers") and [redacted] contains these particular provisions.

[redacted]
(Exhibit [redacted], pg. [redacted]).

"[redacted]." Id. at [redacted].

In Section [redacted], page [redacted], labeled "[redacted]", [redacted] and [redacted] agree as follows:

- [redacted]
- [redacted]

- [redacted]
- [redacted]
- [redacted]

In Section [redacted], page [redacted], labeled "[redacted]:" is the following:

- [redacted]

Id.

- [redacted]

[redacted]

Id. at pg. [redacted].

Section [redacted], page [redacted], labeled "[redacted]" in relevant part states:

[redacted]

Id.

DISCUSSION

The unambiguous language of the contracts clearly demonstrates that these are service contracts to provide [redacted] over an agreed term of years.[4/] [redacted] receives a non-recurring, non-refundable payment to provide [redacted] over the term of the contract. These amounts are then transferred to [redacted] and [redacted] to deliver the [redacted].

All the payments received from all the contracts were wire transferred directly into account #[redacted] at [redacted] The funds were not segregated. No restrictions were placed on their use.

[redacted], by virtue of the consolidated return in which [redacted] and [redacted] were members, received these amounts from customers from whom it had [redacted] and for which the payments were made. Insofar as the contract and facts demonstrate, under no circumstances would [redacted] or any of its subsidiaries be required to return any portion of these advance payments.

Further, based upon existing statutes, case law and regulations, where there is actual receipt and unrestricted use, as in this case, all events have occurred that call for inclusion of the amounts received in income in the year of receipt, i.e., the [redacted] taxable year. This is so whether these amounts were received for services, as the Service contends, or for the sale of goods as the taxpayer contends.

1. Taxpayer bound by the form of its transaction.

The Supreme Court has held that the substance rather than the form of the transaction governs for federal income tax purposes. Commissioner v. Court Holding Co., 324 U.S. 331

[4/]As set forth above, it is also our position that the taxpayer is at least in part providing a license for the use of its [redacted]. Prepaid license income must be reported in income when received under Treas. Reg. §§ 1.61-8 and 1.451-1(a). The analysis below, concerning services and the "all events" test is equally applicable to license agreements. As such, the analysis of prepayments for services, with the exception of the special deferral for services, incorporates license agreements.

(1945); Gregory v. Helvering, 293 U.S. 465 (1935). However, Supreme Court precedent also provides that a taxpayer may not generally invoke the substance over form principle to disavow the form of a transaction it has structured. City of New York v. Commissioner, 103 T.C. 481, 493 (1994), aff'd, 70 F.3d 142 (D.C. Cir. 1995), citing Commissioner v. National Alfalfa Dehydrating & Milling Co., 417 U.S. 134, 149 (1974). See also Higgins v. Smith, 308 U.S. 473, 477 (1940).

The rationale behind the rule rests in the taxpayer's freedom to organize its affairs as it chooses, as well as the uncertainty resulting from allowing a taxpayer subsequently to choose an alternative form that produces a lesser tax. City of New York, 103 T.C. at 493, citing National Alfalfa, 417 U.S. at 149, and Television Indus., Inc. v. Commissioner, 284 F.2d 322, 325 (2d Cir. 1960). Thus, the taxpayer has been held to have less opportunity to challenge the form of their transactions than the government. See Palo Alto Town & Country Village, Inc. v. Commissioner, 565 F.2d 1388, 1390 (9th Cir. 1977); Coleman v. Commissioner, 87 T.C. 178, 202 (1986), aff'd in an unpublished order, 833 F.2d 303 (3d Cir. 1987).

Significantly, the Second Circuit "has firmly refused to allow such challenges" in circumstances "[w]here the form of the transaction was adopted primarily to avoid taxes." In re Tax Refund Litigation, 766 F.Supp. 1248, 1263 (E.D.N.Y. 1991), aff'd in part and rev'd in part on other issues, 989 F.2d 1290 (2d Cir. 1993), citing Hoffman Motors Corp. v. United States, 473 F.2d 254, 257 (2d Cir. 1973); Frelbo v. Commissioner, 315 F.2d 784, 786 (2d Cir. 1963).

As a result, cases where the government challenges the form of the transaction must be carefully distinguished from those in which the taxpayer challenges its own transaction. See In re Tax Refund Litigation, 766 F.Supp at 1263, stating "there is little unfairness in binding the [taxpayer] here, although the government would not be bound if it challenged the form of this transaction." Thus, the taxpayer, challenging its form, may be prevented from relying on precedent that would otherwise apply to the facts. See, e.g., Bradley v. United States, 730 F.2d 718, 720 (11th Cir.), cert. denied, 469 U.S. 882 (1984); Taiyo Hawaii Co., Ltd. v. Commissioner, 108 T.C. 590, 602 (1997); Estate of Durkin v. Commissioner, 99 T.C. 561, 569 (1992).

In the situation presented, the taxpayer structured the form

of its transaction and is now trying to re-characterize it to avoid tax. In effect, the taxpayer is challenging the transactions it structured. It is not the Service that is attempting to re-characterize the transaction.

Here, all the agreements were termed "[redacted]". All contracts state that the taxpayer will deliver services. Nowhere is there any mention of a sale of [redacted], or any other goods.

It is our position that not only are these agreements service contracts, but that the taxpayer should be bound by its characterization of the transaction. Further, the taxpayer's attempt to challenge the clear language of the contract is merely an attempts to substantially reduce its tax burden.

2. Receipt of Prepayments For Goods and Services

(a) General Principles

Income must be reported in the taxable year in which the taxpayer receives it unless, under the taxpayer's method of accounting, the item of income is properly accounted for in a different period. I.R.C. § 451(a). [redacted] is an accrual method taxpayer. Accrual method taxpayers generally must recognize income when "all events" have occurred which fix the right to receive the income and the amount of the income can be determined with reasonable accuracy. Schlude v. Commissioner, 372 U.S. 128, 137 (1963); Treas. Reg. § 1.446-1(c)(1)(ii), 1.451-1(a).

Accrual basis taxpayers must include in income in the year received, non-refundable advance payments from the sale of **services** that are unrestricted as to their use, even though those payments may not be earned until later years. Schlude v. Commissioner, supra; American Auto Association v. United States, 367 U.S. 687, 689 (1961); Automobile Club of Michigan v. Commissioner, 353 U.S. 180, 189 (1957).

The same principles generally apply to advance payments for the sale of **goods**. That is, non-refundable prepayments received without restriction as to the use are includible in income on receipt because the receipt fixes the taxpayer's right to income. Graber, Inc. v. Commissioner, 51 T.C. 733, 735-736 (1969); Hagen Adver. Displays, Inc. v. Commissioner, 47 T.C. 339, 146-147 (1966), aff'd 407 F.2d 1105, 1107 (6th Cir. 1969).

In the instant case [redacted] through its affiliates received from customers an up-front, non-recurring, non-refundable charge for [redacted] during the [redacted] taxable year. [redacted] had an unrestricted right to use these payments upon receipt. There were no restrictions on [redacted]'s use of these payments. All payments were made via wire transfer to an account at [redacted] for [redacted], Acct. #[redacted].

Of these amounts approximately $[redacted] and $[redacted] were then transferred to [redacted] and [redacted], respectively.

Upon receipt of payment, all the events had occurred that fixed [redacted]'s right to receive the income, and the income could be determined with reasonable accuracy. See Signet Banking Corp. v. Commissioner, 106 T.C. 117, 128 (1996), aff'd 118 F.3d 239 (4th Cir. 1997). The income is includible in the year received, not when the goods are delivered or the services performed.

It is our position that these so-called [redacted] are essentially service contracts and do no qualify for the limited deferral permitted by Rev. Rul. 71-21, 1971-2 C.B. 549.

However, it is the taxpayer's position that its business involves the "[redacted]". [Ex. [redacted]] They further argue that these advance payments are for the sale of inventory and as such qualify under Treas. Reg. § 1.451-5 for deferral. Ex. [redacted], pgs. [redacted].

Revenue Procedure 71-21, 1971-2 C.B. 549 sets forth the circumstances under which the Service will permit a one-year deferral in the recognition of certain prepaid income for the advance payment of services. Treas. Reg. § 1.451-5 sets forth the circumstances under which the Service will permit a deferral in the recognition of income arising from the advance payment of goods.

(b) Deferral Election For Advance Payments For Services

Advance payments for services to be rendered in the future, like prepaid income, generally are includible in income on receipt by an accrual-method taxpayer if the use of the funds is unrestricted. Schlude v. Commissioner, 372 U.S. 128 (1963); Rev. Rul. 66-347, 1966-2 C.B. 196. The payments must be accrued even if they have not been earned and even though subject to a possibility of repayment. Id.

Thus, as a general principle, income received under a service contract generally cannot be deferred over the term of the contract. Streight Radio & T.C., Inc. v. Commissioner, 280 F.2d 883 (7th Cir. 1960). However, there are exceptions to the rule preventing deferral, including the one-year deferral rule for prepaid service income.

In some situations, an accrual-method taxpayer may elect to defer reporting unearned advance payments for services until the tax year following the year of receipt. Rev. Proc. 71-21, 1972-2 C.B. 549. A taxpayer, under an agreement for services, who receives a payment in one tax year when all the services are required by the agreement as it exists at the end of the tax year of receipt to be performed before the end of the next succeeding tax year, may defer amounts due and payable. Id.

The deferral election only applies to agreements that extend over two consecutive tax years, i.e., the year the advance payment is received and the following year. If the services under the agreement are not entirely performed by the end of the second year, the taxpayer must include the entire amount of the advance payment not previously included in income. Id.

This special treatment reconciles the tax and financial accounting treatment of payments made in one year for services to be rendered in the next and facilitates the reporting and verification of items of income from the standpoint of the taxpayer and the Service. Rev. Proc. 71-21, § 2, 1971-2 C.B. 549. Once the deferral method is adopted by the taxpayer, it must be consistently used. The agreement need not be written, but it must relate to the performance of services.

Thus, when the all events test would otherwise require inclusion of items in income, this procedure permits a deferral until the next year when the service is rendered.

If the agreement provides, however, for the performance of any services after the end of the tax year immediately following the year of receipt, or if services can be performed at an unspecified date in the future, the deferral is not available. Rev. Proc. 71-21, 1971-2 C.B. 549; see Rev. Rul. 72-207, 1972-1 C.B. 126.

In the situation presented, none of the [redacted] **by their terms** provide that all services required to be rendered must be performed before the end of the next succeeding year.

The contracts are to provide services over [redacted] year periods. Clearly, a portion of the services will be performed at an unspecified date that will be after the year following the year of prepayment.

[redacted], (b)(5)(DP)

[redacted], (b)(5)(DP)

[redacted] (b)(5)(DP),

[redacted] (b)(5)(DP),

[redacted], (b)(5)(DP)

[redacted], (b)(5)(DP)

(d) Deferral Election For Advance Payment for Goods

Income must be reported in the taxable year in which the taxpayer receives it unless, under the taxpayer's method of accounting, the item of income is properly accounted for in a different period. I.R.C. § 451(a). Advance payments for sale of merchandise and long-term contracts are includible in income on receipt by an accrual method taxpayer. Hagen Advertising Displays, Inc. v. Commissioner, 41 T.C. 139 (1966), aff'd 407 F.2d 1105 (6th Cir. 1969).

In Hagen Advertising Displays, the taxpayer which sold custom-made illuminated signs entered into "blanket order" contracts under which its customers would agree to buy a certain number of signs meeting particular specifications. The court held that advance payments under these contracts were income as received, rejecting any distinction between advance payments for goods and services, at least in the case of inventoriable goods. Id. at 146-47.

The Sixth Circuit affirmed, reasoning that the repeal of I.R.C. § 452, which covered advance payments for goods as well as services, should carry similar implications for both transactions.

In S. Graber, Inc. v. Commissioner, 51 T.C. 733 (1969), the court held that:

> [U]nder accrual accounting where there is actual receipt... and the funds are at the unrestricted use of the taxpayer all events have occurred that call for accrual and that no further inquiry is necessary to determine whether the income have been earned.

Id. at 735.

The court held further that:

> [A]dvance payments constitute income when received and petitioner is required to include these amounts which it received as advance payments without restriction as to use or disposition, in its return as income in the taxable year in which it received them.

Id.

Finally, the court expressly rejected the notion that the fact that the advance payments were refundable would make any difference, stating that,

> [T]he possibility of refunds was nothing more than a contingent liability which had no bearing on the taxpayer's right to the [payment] when received.

Id. at 736.

With respect to the facts presented, [redacted] though its affiliates, required its customers to make substantial upfront payments. There was no restriction on its use of these payments when made, as they were wired directly into a non-segregated bank account. All events had occurred that fixed [redacted]'s right to receive the income, and the income could be determined with reasonable certainty.

Therefore, [redacted] may not defer reporting of the advance payments in the [redacted] taxable year unless it qualifies under

Treas. Reg. § 1.451-5.

It is [redacted]'s contention that they properly treated these prepaid amounts as "advance payments" under Treas. Reg. § 1.451-5. Under this regulation, accrual basis taxpayers that receive advance payments (e.g., customer deposits) in one taxable year may, in certain circumstances, defer reporting the payments in gross income. An advance payment is a payment which is to be applied to a contract not completed during the taxable. Treas. Reg. § 1.451-5(a).[5/]

Treasury Regulation § 1.451-5(a)(1) provides in relevant part, as follows:

> For purposes of this section, the term "advance payment" means any amount which is received in a taxable year by a taxpayer using an accrual method of accounting for purchases and sales or a long-term contract method of accounting... pursuant to, and to be applied against, an agreement:[6/]
>
> > (i) For the sale or other disposition in a future taxable year of goods held by the taxpayer primarily for sale to customers in the ordinary course of his trade of business, or
> >
> > (ii) For the building, installing, constructing or manufacturing by the taxpayer of items where the agreement is not completed within such taxable year.

Advance payments are includible in income in the taxable year in which the gross receipts from the contract are properly includible under the taxpayer's method of accounting. Treas. Reg. § 1.451-5(b).

[5/]Treas. Reg. § 1.451-5 was promulgated in response to Hagen Advertising Display, Inc. v. Commissioner, 41 T.C. 139 (1966), aff'd. 407 F.2d 1105 (6th Cir. 1969).

[redacted]

Treasury Regulation § 1.451-5(b), provides in relevant part, as follows:

> (b) Taxable year of inclusion. --(1) In general. Advance payments must be included in income either -
>
> (i) In the taxable year of receipt; or
> (ii) Except as provided...[for inventoriable goods].
>
> (a) In the taxable year in which properly accruable under the taxpayer's method of accounting for tax purposes if such method results in including advance payments in gross receipts no later than the time such advance payments are included in gross receipts for purposes of all of his reports (including consolidated financial statements) to shareholders, partners, beneficiaries, other proprietors, and for credit purposes, or
>
> (b) If the taxpayer's method of accounting for purposes of such reports results in advance payments (or any portion of such payments) being included in gross receipts earlier than for tax purposes, in the taxable year in which includible in gross receipts pursuant to his method of accounting for purposes of such reports.

Thus, an accrual method taxpayer may defer income on advance payments received for (a) the sale in a future taxable year of goods held by the taxpayer primarily for sale to customers in the ordinary course of business; or (b) the building, installing, constructing, or manufacturing by the taxpayer of items where the agreement is not completed within the taxable year. Treas. Reg. § 1.451-5(a).

As set forth above, we reiterate that it is our position that these "[redacted]" are clearly service contracts which do not qualify for any deferral.

However, in response to [redacted]'s arguments we also contend that they may not use Treas. Reg. § 1.451-5 because they did not hold "[redacted]" [redacted], or

[redacted] of [redacted].

First, it cannot be reasonably argued that [redacted], through its subsidiaries, holds [redacted] primarily for sale to customers in the ordinary course of business. [redacted] did not hold [redacted] for sale because they admit that they had "[redacted]". Ex. [redacted].

Nowhere in any of the "[redacted]" reviewed was there any reference to the sale of [redacted]. The customers did not contract to buy [redacted]. [redacted] and [redacted]. The [redacted] that are used are incidental to the provision of the contracted service.

The taxpayer relies on PLR [redacted], TAM [redacted] and TAM [redacted] for the proposition that [redacted]

[redacted]

[redacted]

[redacted]". Ex. [redacted] pg. [redacted]. This is not the case.

The subject matter of the "[redacted]" is the provision of [redacted] to customers. The terms of the contracts clearly bear this out. Exs. 4a, 4b, 4c.

Although there is no authority that we are aware of which addresses the taxpayer's arguments that a contract to provide

[redacted]

Secondly, these "[redacted]" [redacted]. Again, the plain meaning of the contract clearly reveals a contract for [redacted] and [redacted].

Although [redacted] argues that it [redacted], the contracts themselves were not entered into by customers for the

purchase of [redacted].

[redacted]
, (b)(5)(DP)

Interestingly, the taxpayer, through written memoranda and numerous discussions with the audit team has consistently argued that these prepaid amounts are advance payments relating to inventoriable goods. However, Treas. Reg. § 1.451-5(b) does not apply to the deferral for advance payment for inventory items. Treas. Reg. § 1.451-5(b)(1)(ii).

[redacted] states that the advance payments received during the [redacted] taxable year are income from the "[redacted]". Ex. [redacted], pg. [redacted]. The taxpayer's arguments are as follows:

[redacted]

[redacted]

Id. Emphasis added.

[redacted]

[redacted]

Id. at [redacted]. Emphasis added.

[redacted]

Id. at [redacted]. Emphasis added.

[redacted]

Id. at [redacted]. Emphasis added.

Thus, based upon the [redacted]'s own arguments, the deferral which they elected under Treas. Reg. 1.451-5(b)(1)(ii) is inapplicable since deferral for inventoriable items is governed by Treas. Reg. § 1.451-5(c).

Generally, Treas. Reg. § 1.451-5(c) applies to advance payments relating to inventoriable goods and holds that such payments are includible not later than the second year following the year of receipt.

Specifically, the taxpayer must include these advance payments (essentially profit) in income no later than the end of the second tax year following the tax year in which:

- The taxpayer has on hand, or has available to him through normal sources of supply, goods of substantially similar kind and in sufficient quantity to satisfy the agreement; and

- The taxpayer has received substantial advance payments.

Treas. Reg. § 1.451-5(c)(1).

Treasury Regulation § 1.471-1 provides:

> [I]nventories at the beginning and end of each taxable year are necessary in every case in which the production purchase, or sale of merchandise is an income-producing factor. The inventory should include all finished or partly finished goods and, in the case of raw materials and supplies, only those which have been acquired for sale or which will physically become a part of merchandise intended for sale. . .

Preliminary to any determination of whether the taxpayer is entitled to deferral for the advance payment of goods under Treas. Reg. § 1.451-5 is whether the taxpayer produces, purchases or sells "merchandise" cf. Homes by Ayres v. Commissioner, 795 F.2d 832, 835 (9th Cir. 1986), aff'g. T.C. Memo 1984-475.

Neither the Code nor the regulations define "merchandise" or inventory or clearly distinguish between "materials and supplies" that are not consumed and inventory. Wilkenson-Beane, Inc. v. Commissioner, 420 F.2d 352, 354 (1st Cir. 1970), aff'g. T.C. Memo 1969-79.

Courts have held that "merchandise" as used in Treas. Reg. § 1.471-1 is an item held for sale. Wilkenson-Beane, Inc. v. Commissioner, at 354-355. Consumption of a material in the performance of a service or in a manufacturing process is indicative that the material is a supply, not merchandise held for sale. Osteopathic Med. Oncology & Hematology, P.C. v. Commissioner, 113 T.C. 376, 385 (1999).

[redacted]

If the customers wanted to merely purchase [redacted] they could have done so in any number of ways, since the production of [redacted] is not the exclusive provence of [redacted] or companies that supply [redacted]. The fact that [redacted] is insufficient to transmute the sale of a service to the sale of merchandise.

In any event, even assuming *arguendo* that these payments relate to the sale of inventoriable goods, these amounts received in [redacted] would be includible in income, no later than the second year following the year of receipt. In this case, this would be the [redacted] taxable year, not over a [redacted] to [redacted] year period.

CONCLUSION

The "[redacted]" which [redacted], through its subsidiaries entered into were for the provision of services. A review of these agreement readily indicates that [redacted] was to provide [redacted] period depending upon the particular agreement.

Each of these agreements required that the customer remit a non-refundable upfront charge. These [redacted]. [redacted] had an [redacted] right to use these payments.

Upon receipt of payment, all events had occurred that fixed the taxpayer's right to receive the income and the income could be determined with reasonable accuracy. Therefore, these non-recurring, non-refundable payments are includible in taxable year [redacted], the year of receipt.

[redacted], (b)(5)(DP)

Further, the taxpayer does not qualify for deferral under Treas. Reg. § 1.451-5.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

We are closing our file. If you have any questions on this matter, please do not hesitate to contact us.

[redacted]
Associate Area Counsel
LMSB, Area 1

By: [redacted]
Attorney (LMSB)

LIST OF MATERIAL FOR REVIEW

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